SOME NEGLECTED PHASES OF RATE REGULATION

Fluctuating Prices and the Earnings of Capital

Although the connection between rising or falling prices and the rate of interest has long been recognized, there is little evidence that the knowledge of this fact is a working force in business; and the writer has as yet seen no attempt to apply it to the problems of regulation. Yet in deciding what is a reasonable rate of return on capital invested in a quasi-public enterprise, surely we cannot claim to have settled the question with perfect justice if we ignore the fact that a five per cent income, thinned by a two per cent annual loss in the purchasing power of the principal, is no better than three per cent would be in an era of stable prices, or one per cent at a time when prices are falling two per cent a year. And especially if the market rate of interest changes so as to make the real return more nearly equable, must not this play some part in calculations of just compensation?

That business men themselves are slow to recognize this fact must have been the conclusion of any one who reads their utterances in the financial journals during the recent depression, notably in the matter of the low prices of high-grade securities and the high rates of interest necessary to float new bond issues. These rates were not high enough to be more than a tardy and partial compensation for the great fall in the purchasing power of money which began in 1896. Possibly, if this fact were fully realized by business men, they would not regard every rise in interest rates with so much alarm, nor feel that the soundness of credit is tottering on the brink of disaster merely because interest rates are unusually high.

If the resistance to an inevitable rise of interest rates takes the shape of substituting preferred stock for bonds, as it seems to have done in part, this may of itself prove to be a wholesome feature, making for fewer receiverships. But the virtue lies not in refusing to pay a high rate; rather in compelling the investor, in exchange for a frankly high rate of return, to accept a security that carries no right of foreclosure if the specified rate is not paid. To appreciate how wholesome such a change may be, one need only realize that the railroads have been so fully bonded already that in 1911 only 38.9 per cent of their outstanding securities (not owned by railroads) were stocks, and 61.1 per cent

were classed as funded debt.[1] But can a policy be wholly good which is founded on ignorance? which assumes that the situation is due to one set of causes of a very transient sort when the probability is that it is really due in part to another chain of causes far more permanent?

To a considerable extent, the roads followed the more risky policy of borrowing on short-time notes, trusting to be able to refund them at lower rates of interest when they should fall due. They were acting on the supposition that the "stringency" was to be temporary. And the result at the moment of writing these words[2] bids fair to justify their expectations. But is this always a safe policy to follow when rates of interest are higher than they have been for the decade preceding? What if the "stringency" is chiefly the result of a shrinking dollar, and what if the dollar should go on shrinking? The recent high rates of interest on good securities were not great enough to compensate the lender fully for the annual cheapening of his principal. If the present fall of prices is merely temporary and if they recover and go on rising as before, we may expect the compensation to become more perfect. In that case, interest rates might rise higher still, to the disappointment of those who had counted on being able to refund at a saving. The issuance of short-time notes to raise funds for more or less permanent equipment is always risky financing, and those responsible should be very sure that the stringency is due to temporary causes before they take the chance.

I am not denying the fact that periodical swings of prices are involved in the cycles of business activity and depression so searchingly analyzed in the recent monumental work of Professor W. C. Mitchell. But these swings are superimposed on other longer movements that seem to spring from changes in the supply of specie in its relation to the industrial demand, to the volume of exchanges, and to the volume and the long-run efficiency of the machinery of credit. As a result, the normal levels of prices, and even of interest rates, to which the business world returns on completing one of these cycles, are not likely to be exactly the same levels as those which prevailed at the beginning of the period.

For instance, at the present moment, the great rise in prices which has lasted over fifteen years seems to have been checked. If this is but temporary, rates of interest may remain high, despite recovery from the "silent panic" of 1913. But if this is the be-

[1] *Statistics of Railways, 1911,* Interstate Commerce Commission, p. 33.

[2] May, 1914.

ginning of a long downward movement, then we should look for lower and lower interest rates, more like those which prevailed toward the end of the last great fall in prices. So far as the fall in prices in the United States may be due to the revision of the tariff, it is not likely to continue. So far as it may be due to the slight falling off of gold production which was reported for 1913, that seems to have been due to temporary causes. Clearly it is not yet safe to build on the hope that the day of high prices is over. Sound business management demands serious study of these things.

But the business man has a better excuse for ignoring them than have those engaged in the task of public regulation, for he is not supposed to be looking after any one's welfare but his own. To be sure, as all know, his mistakes do hurt his neighbors and all with whom he has business dealings, but at least the sinfulness of his blunders is not marked upon him, as upon the judge or utility commissioner, by the badge of official responsibility. Moreover, we are satisfied if the business man succeeds in the task of shrewdly forecasting the actual course of earnings and expenses, while the public official is popularly supposed to be dealing with the ethical issue of fairness. The business man can perhaps afford to throw ethics to the winds and to ignore changes in prices that bring him an unearned increment at the expense of investors (and wage-earners), provided only they are not followed by changes in wages and interest. But can the regulator of rates acquit his conscience so easily?

Arbitrators of railroad wage disputes are giving out awards based on the increased cost of maintaining a reasonable standard of comfort, and "putting it up to" the Interstate Commerce Commission to allow higher rates in case the present scale of charges is not high enough to pay the increased wages and still leave a reasonable return on invested capital. But, so far, there is little indication that regulating boards have taken a corresponding attitude toward the effect of rising or falling prices on the investor. If there is an independent standard of fairness to investors similar to the conception of a fair standard of living for wage-earners, surely that standard demands that, in an era when prices have long been rising at an average rate of over three per cent a year, investors should receive three per cent more than in an era of steady prices, and six per cent more than they should be allowed if prices were falling at the same rate.

But in practice the standard of fair returns to capital is not independent of the market rates; it is borrowed from it, and the fairness sought is fairness as between investors in quasi-public enterprises and those in private industry, without troubling as to the obvious query whether the competitive rate is itself "fair" to investors at times of changing price movements. Or, to put it on grounds of expediency, we are searching for the minimum rate necessary to attract private capital in the needed amounts. Such a policy must in the long run give the investor more in periods of continued rising prices than at other times—at least as much more as the market itself does in fixing the rate on new loans. This would not be as much as was suggested in the preceding paragraph, but it would be something.

Courts have recognized the competitive or market rate, with its fluctuations, as controlling their decisions,[3] but we may still wonder if there will not be a certain tendency for the judicial standard to become rigid, to ignore the short fluctuations of the market, and to be rather unresponsive even to the most fundamental and long-continued movements. This would be neither fairness nor expediency. Is not the present a time when both fairness and expediency urge allowing a considerably higher rate of return than was reasonable twenty years ago? Not that the extra high return should be guaranteed for an indefinite time in the future, when prices may have stopped rising and begun to fall. The extra earnings needed to allow for price changes cannot reasonably be expected to last longer than the conditions which make them necessary.

Of course it would be conceivably possible to fix on a "fair" rate of earnings and add or subtract automatically each decade the full amount of the average annual change in the index number of prices for that decade, or to use a tabular standard in calculating both payments of interest and repayments of principal. But this would hardly be useful as a standard to guide in rate regulation unless it were adopted also as the method of handling bonds, not only in quasi-public industries but in others as well. What we may perhaps expect without straining the imagination is that as business men take a more and more intelligent interest in general statistics of business conditions, they will apply their knowledge of price changes to their individual borrowings and especially

[3] *Steenerson* v. *Gt. No. Ry. Co.*, 69 Minn. 353; cited, with other federal and state cases, in Beale and Wyman, *Railroad Rate Regulation*, pp. 389-398.

to their calculations of their own true profits and losses, on which their demand for loans must be based; and that as a result the market rate of interest will compensate much more closely than in the past for the ups and downs of prices. If this occurs it will become a fact which the officials charged with regulating rates can no longer by any possibility ignore.

It may be suggested that the demand for high earnings came rather late in the day to be attributed to a price movement that began in 1896. For obvious reasons, the long-term securities are the last to feel the effect of price movements.[4] Moreover, I make no claim that the point here raised is the whole explanation of any great money stringency or even a major part of it, merely that it is one important and much-neglected element in the problem. But there is one further feature of the situation in regulated industries which may furnish a partial answer to the objection here raised.

Surplus Accumulated out of Earnings

These businesses, particularly the railroads perhaps, have made large betterments out of earnings, often charging them to operating expenses; in fact, the claim that the roads, as a whole, are not now overcapitalized rests on the additions made in this way to their tangible assets. And they have used this disguised reinvestment of earnings as an argument against the lowering of rates to a basis that would yield only a fair return on their (smaller) original investment, while at the same time pleading the low cash dividends as evidence that their returns were not and had not been unreasonably high. They wanted to get the benefit of the reinvestments in future dividends on their value, but not to have them counted in calculating past earnings for purposes of regulation. Yet, obviously, the stockholders' share of the dividend-paying surplus of their own road is as good as a cash dividend invested in new securities. They would eat their cake and have it too—as who would not if he could, particularly if future cakes seemed in danger of being reduced to unreasonably small size?

In recent years this policy has been brought to issue in ways which mean that the true rate of earnings can no longer be concealed in this fashion. If the ends of regulation are to be accomplished, reinvested income must appear as income when it is

[4] *Cf.* Mitchell, *Business Cycles,* esp. pp. 145, 467.

reinvested and not be disguised as a part of operating expenses, or else the owner cannot justly produce it from its hiding place at some later date, and demand dividends on it. The accounting system prescribed by the Interstate Commerce Commission under the law of 1906 is of great significance in preventing such concealment, though the issue had been raised previously.[5] In 1911 the commission went farther, and refused to allow the claim made by the Burlington road to the current rate of dividends on the full $530,000,000 which that company claimed as the "present value" of their property, less than half of this being covered by original investment from the sale of stocks and bonds, and $76,-000,000 being carried on the books as surplus.

Without assuming to settle the broad issue whether the right to earnings on this huge surplus is a part of present railroad property which the fourteenth amendment would protect, the commission decides that a surplus on which returns cannot be earned without raising rates to do so is not to be protected to the extent of allowing the increase in rates.[6] Thus the ability to earn dividends on these extensions and betterments without raising rates, is taken apparently as a rule-of-thumb test of the more fundamental question whether the earnings on the surplus are justified by "an additional service given" by the increase in facilities. If a station lunch room is decorated with old masters, this investment is entitled to dividends only if they can be earned at the old rate of charges.

Obviously, such a test as this ignores the fact of the dwindling dollar; and the railroad might reasonably claim that if the dollar had not dwindled, they would have been able to meet the test and earn fair returns on their surplus without raising rates, and that they should not be made to suffer merely because an oversupply of gold has lowered its purchasing power. However, in this case the surplus resulted from past earnings that were high

[5] See especially Yellow Pine Association Case, 10 I.C.C.R. 505, affirmed in *Ill. Centr. R.R. Co.* v. *Commission,* 206 U. S. 441 (1907). See also "*In re* Advances in Rates (Eastern Case)," 20 I.C.C.R. 243, 267-270. Other cases cited in Whitten, *Valuation of Public Service Corporations,* pp. 176-189.

[6] *In re* Advances in Rates (Eastern Case), 20 I.C.C.R. 243, 269-270. Also Whitten, *op. cit.* It seems probable that as these funds are accumulated out of earnings which the public permitted at the time they were made (whether wisely or not, knowingly or in ignorance) it would be considered retroactive regulation to deny that they are now the property of the corporation. But is it "reasonable" to allow as high a rate of earnings on this as on the stockholders' original investment?

enough to have been considerably reduced without being made unreasonably low, provided they had been brought to public notice by being divided instead of being reinvested. And in any case in which a corporation has actually avoided downward regulation of its earnings by unobtrusively placing part of them in an inside pocket, it will probably fail to stir the depths of popular sympathy by its claim to dividends on this accumulation.

But whatever the case of the Burlington may be, is it not possible that before the reins were thus tightened railroads in general got on with a rate of cash dividend that was, by itself, unreasonably low, at least when compared with the par value of stocks, but was supplemented as has been shown? and that public officials got used to these unduly low rates as presumably reasonable and sufficient? But now this hoard has been brought to light, and the commission has set its face against allowing indefinite further additions beyond the reasonable rate of dividend, until the question shall be settled whether the roads have a vested right to the current rate of earnings on such accumulations, both those of the past and those still to come. May it not be that the part of the roads' past income that is thus called in question was, in the decade following 1896, the part that kept the whole from being unduly low?

If betterments, beyond the limits of the recognized functions of surplus, are to be allowed as a basis for future dividends, they must be counted as part of present net income, on the same footing as cash dividends. If it is to be decided that the roads have no vested claim to dividends on such betterments, then they will have lost one form of income which has played a vital part in their past development. And so long as no decision is reached, the uncertainty itself will make a higher yield necessary if investors are to be attracted to purchase railroad stocks, other than preferred stocks with limited dividends.

In either case, ideas of reasonable earnings that are based on past cash dividends will almost certainly have to become somewhat more liberal. And this is for the public interest, in order to attract the capital needed for the service of the public, in rivalry with competitive enterprises which also have the habit of accumulating surplus out of earnings when the earnings are large enough.

If this is a true statement of the case, it has a bearing on the previous discussion of rising prices, and goes far to explain why it is only in recent years that the roads have felt, in pressure for

higher dividends, a force which was set in motion some eighteen years ago, when the great fall in the purchasing power of the dollar began. During the earlier part of this period, nominal rates of dividend were of little importance, for they could be supplemented by betterment-dividends to any extent short of obvious extortion, unchecked and virtually unheeded. And it is only in the latter part of this period that regulation, either of railroads or of public utilities, has had a decided effect on the level of earnings or on the practice of charging betterments to operating expenses. This, of course, can affect the rate of interest on bonds only if the policy of betterments made out of earnings is retarded under the present policy of regulation, and the security of future issues thus made poorer.

Betterments and Public Necessity

One point raised in the foregoing discussion seems to deserve separate treatment. Nothing that has been said should be taken to imply disapproval of the practice of reinvesting earnings—merely of dodging regulation by using such reinvestment for purposes of concealment. But it does seem clear that the stockholder should not gain any rights or privileges by leaving part of his earnings in the business which he would lose if he took the earnings all out in cash and then used part of them in subscribing to new issues of stock.

And among the rights or privileges he should not thus gain is exemption from the common requirement that a showing of public necessity be made as a condition of allowing private capital to be invested in quasi-public enterprises. This frequently takes the form of requiring that a "certificate of convenience and necessity" be issued before a new company can begin operations, and in some cases before new construction can be undertaken by an existing company.

But there is no such regulation governing the making of betterments in existing properties, paid for out of earnings. There are, to be sure, these two generally recognized principles: first, that extravagant expenditures cannot be included in the "fair value" of the property; and, second, that only such property as is used and useful in the public service can be so counted. Under the former principle, if the directors buy old masters to hang in the station lunch rooms, a commission might investigate whether they had paid more than the necessary price, while under the

second principle they might go so far as to cast doubt on the usefulness of these decorations in furthering the transportation of the traveling public.

Whether either or both of these things is to be accomplished in the future will depend largely on the method and effectiveness of the valuations which the Interstate Commerce Commission now has power to make of the property of the railroads. In the past, the principal check of this sort seems to have been exercised by those states which supervised the expenditure of funds raised by the issuance of new securities—a check which would obviously not apply to betterments made out of earnings.

But if the measure of vigilance is the strength of temptation to abuse, should not the supervision logically be stricter in the case of reinvested earnings rather than more lax? For the easier the funds are come by, the greater the temptation to lavish expenditure. Under the circumstances, it is no insult to the officials of the railroads if we raise the question whether the funds under discussion have not possibly been spent, some of them, with a lavishness which might have been somewhat restrained without injury to the public interest. At least there seems to have been some opportunity for this.

In further safeguarding the public (if that be necessary) against having to pay dividends on little-needed "betterments," it would probably be unwise to use the same methods employed in the case of new issues of securities. Government is ever in danger of using a steam hammer to crack a walnut. Probably an effective valuation would prove sufficient, but the valuation should determine not only the reasonably necessary expense of constructing the property as found, but should further decide whether the facilities themselves are such as are reasonably necessary to the public service for which the public pays.

The contentions for which I have argued may be summarized as follows. First, if the depreciation of gold continues, it will probably call for higher rates of income on investments, including those in quasi-public industry, than the returns to which we have become accustomed. But if prices are to fall steadily from now on, all industries may be able to borrow more cheaply than at present, and the "reasonable return" in public service industries may be lower than at present. Second, if betterments made out of earnings are entitled to future dividends at the current rate,

the amount of such betterments should be counted exactly as if they were cash dividends for purposes of regulation of charges, but if this is done, it will be public policy to allow a higher total return than that which we are accustomed to consider reasonable. Third, if earnings are to be allowed on such betterments, it becomes advisable to see to it that they are expended with reasonable economy and for purposes whose public importance justifies the outlay, with at least as much care as we spend in safeguarding the expenditure of funds raised by the issue of new securities.

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